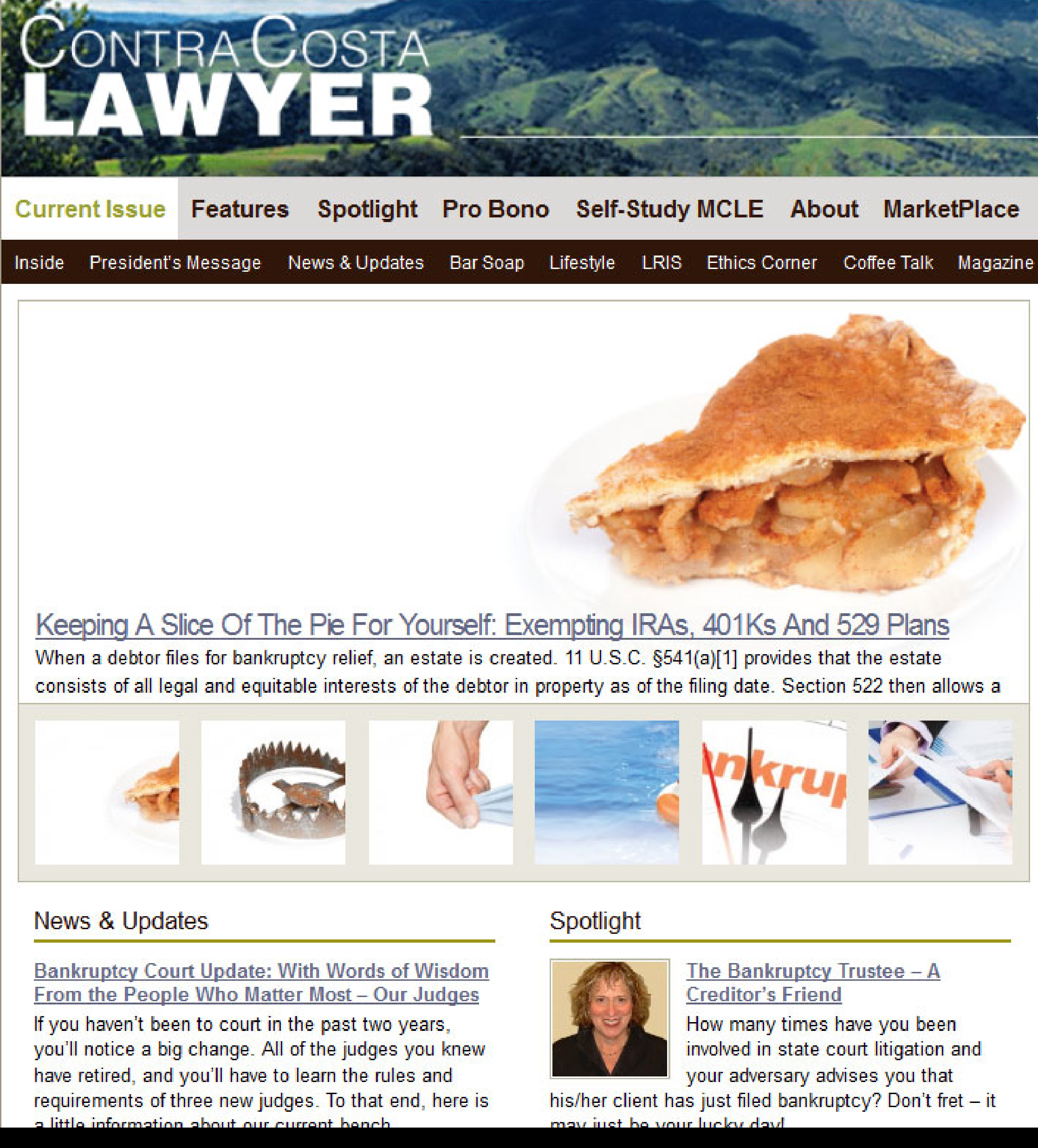

CONTRA COSTA LAWYER

Current Issue | Features | Spotlight | Pro Bono | Self-Study MCLE | About | MarketPlace

Inside | President's Message | News & Updates | Bar Soap | Lifestyle | LRIS | Ethics Corner | Coffee Talk | Magazine

Keeping A Slice Of The Pie For Yourself: Exempting IRAs, 401Ks And 529 Plans

When a debtor files for bankruptcy relief, an estate is created. 11 U.S.C. §541(a)[1] provides that the estate consists of all legal and equitable interests of the debtor in property as of the filing date. Section 522 then allows a

News & Updates

Bankruptcy Court Update: With Words of Wisdom From the People Who Matter Most – Our Judges

If you haven't been to court in the past two years, you'll notice a big change. All of the judges you knew have retired, and you'll have to learn the rules and requirements of three new judges. To that end, here is a little information about our current bench.

Spotlight

The Bankruptcy Trustee – A Creditor's Friend

How many times have you been involved in state court litigation and your adversary advises you that his/her client has just filed bankruptcy? Don't fret – it may just be your lucky day!

Contra Costa Lawyer **Online**

June 2012

Bankruptcy & Real Estate

Contra Costa Lawyer Online

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Contents

Inside: Bankruptcy & Real Estate

Friday, June 1, 2012

In this edition of the Contra Costa Lawyer[1], we explore and discuss the impact and significance of both time-tested and newly articulated aspects of both bankruptcy and real estate law. In these (still) troubling and unsettled economic times, it behooves almost all legal practitioners to have at least an awareness of certain basic tenets of bankruptcy law in order to have a general discussion concerning the prospect of a bankruptcy with one's clients. In this issue, we have selected some of the lesser known, but significant, issues of which practitioners should be aware in the bankruptcy context. We also examine certain established and developing law in the area of real estate and its interaction with bankruptcy law.

The advent of a bankruptcy filing, as we learn, can potentially both protect certain assets from, and expose other assets to, the reach of creditors. In the article entitled *Keeping a Slice of the Pie for Yourself: Exempting IRAs, 401Ks and 529 Plans*[2], ***David Arietta*** explains how and to what extent these plans may be protected from creditors in a bankruptcy. In the article entitled *Proprietor Beware: Corporate Refuge Can Ensnare*[3], ***David Katzen*** discusses the perils of having elected to conduct business in the corporate or limited liability company form when seeking protection from the bankruptcy court.

When representing creditors, the threat or actual filing of a bankruptcy is typically viewed as an unwelcomed development, to say the least. However, ***Marlene Weinstein*** informs us in her article entitled, *The Bankruptcy Trustee – A Creditor's Friend*[4], of the various ways in which a bankruptcy trustee may actually enhance a creditor's position vis-à-vis the debtor. ***Marlene Weinstein*** also offers advice regarding the necessity of preserving divorce-related claims in her article entitled,*Family Law Attorneys Beware: Possible Exceptions to the Chapter 7 Bankruptcy Discharge*[5].

[1] http://www.contracostalawyer.org
[2] http://cclawyer.cccba.org/?p=4168
[3] http://cclawyer.cccba.org/?p=4161
[4] http://cclawyer.cccba.org/?p=4106
[5] http://cclawyer.cccba.org/?p=4150

As we expand our view of bankruptcy to include its interface with real estate law, we must acknowledge that many homeowners are seeking bankruptcy protection as a result of the housing crisis, which has left them owing more on their residence than it is worth. ***Steve Knuppel***, in his article entitled *Lien Strip Basics and the Evolving Law on "Chapter 20"*[6], details the procedure for removing a junior lien from a debtor's residence in the bankruptcy court, thus providing a certain degree of relief to such debtor. A hot off the press Ninth Circuit Case, which could effectively eliminate a debtor's right to retain proceeds from the sale of a homestead claimed as exempt, is discussed in the Pro Bono Section and highlighted via the emergency petition for rehearing filed by Katzen & Schuricht[7]. In the article entitled *To file or not to file: How the timing of the bankruptcy can impact the exclusion of cancellation of indebtedness income*[8], ***Mark Ericsson*** provides an explanation as to the tax treatment of debt forgiveness in the bankruptcy context.

Finally, we address a significant new case in real estate law concerning the dangers of using unartfully drafted letters of intent. In the article entitled *Unintended Consequences of Preliminary Agreements*[9], written by ***Roger Brothers*** (and contributed to by ***Dominic Signorotti*** and ***Ericka Ackeret***), we are made aware of *First National Mortgage Company v. Federal Realty Investment Trust* (631 F. 3d 1058 [9th Cir. 2011]), in which the Ninth Circuit held that a preliminary agreement not necessarily intended as a final expression of the parties intent may be nonetheless enforceable, under certain circumstances.

We hope that you find this edition to be interesting and enlightening.

[6] http://cclawyer.cccba.org/?p=4139%20
[7] http://cclawyer.cccba.org/?p=4091
[8] http://cclawyer.cccba.org/?p=4131
[9] http://cclawyer.cccba.org/?p=4116

Access to Justice in the Wake of Budget Cutbacks

Friday, June 1, 2012

This month, an urgent message from our Presiding Judge, Diana Becton: "Justice Delayed Is Justice Denied"

Presiding Judge Diana Becton, Contra Costa Superior Court

When Californians need to assert or preserve their rights, settle disputes, or need protection from physical harm, they deserve to have a judicial system that provides meaningful and timely access. The courts are not optional – we are a third branch of government that fulfills the fundamental role of preserving the rule of law. Chief Justice Tani Cantil-Sakauye observed that "We exist to absolve the evils of the world in a fair manner under the rule of law." The judicial branch must receive adequate funding in order to carry out its constitutional and statutorily mandated functions.

As budget cuts continue to force the Contra Costa Superior Court to reduce staff and services, there is a real and present danger that access to justice is slowing eroding.

Contra Costa Superior Court has 38 Judges and 8 Commissioners. Our court accepts over 196,000 new filings every year.

Since 2008, like all other courts in California, the Contra Costa Superior Court has faced some challenging times. Our court operations budget has been permanently cut from $63 million to $54.6 million. During the last 3 fiscal years we have experienced permanent budget cuts of $8.4M amounting to 13% of our court operations budget.

The upcoming fiscal year's budget (FY 2012-13) imposes massive cuts on the Judicial Branch totaling $350 million statewide. In previous years the reductions to the Judicial Branch have been largely offset by fund shifts and additional revenue from court-related fee increases. Locally, Contra Costa Superior Court permanently cut operating costs to build one-time fund reserves that have assisted our court in maintaining critically needed services. Through the use of one-time reserves, we funded critically needed staff positions to maintain the basic level of services to the public for this fiscal year. While the use of these one-time funds has given our court a temporary reprieve, the cuts that will soon hit will strike a blow that will be felt full force in FY 2012-13. For Contra Costa Superior Court, the cuts will mean an additional $4.1 million in permanent cuts, over and above the $8.4 million cut we have already had to absorb since fiscal year 2008-09.

Contra Costa Superior Court recognized early on that the cuts to our budget were permanent reductions. We saw the urgent need to examine ways we could cut our operating costs, and consequently we have:

Consolidated building leases;

Reorganized training policies to be more cost effective;

Renegotiated services and supply contracts, technology-related contracts and the juvenile dependency counsel contract; and

Reduced legal library expenses.

To increase revenues, our court has:

Enhanced collection efforts on all court fines and fees;

Expanded the ability of parties to use credit cards to make payments;

Enhanced our public website to provide more information for the public regarding self help resources in both English and Spanish;

Drawn down our fund balance to fund critical temporary staff positions; we have not hired permanent employees, and;

Participated fully in the Traffic Amnesty Program.

Regrettably, none of these measures were enough to cover all the cuts we have sustained. The distressing reality is that most of the cuts in our operating expenses have had to be absorbed as staff reductions. In FY 2008-09 the court had 440 employees. Over the past three fiscal years, a total of 128 employee positions were eliminated through attrition (66 people) and layoffs (62 people) bringing our staffing level to 312 employees – a reduction of 29% percent in permanent staffing levels.

Current events could actually make matters even worse. If the temporary taxes proposed by the Governor are rejected by the voters, then there will be another $125 million cut to the Judicial Branch.

Contra Costa Superior Court would then have to cut at least an *additional* $2.1 million. This would mean a reduction to our budget of $6.2 million during fiscal year 2012-2013. If these additional cuts are made, our court will have been cut 23% since FY 2008-09.

Looking behind he numbers, with fewer staff, the court has been forced to cut back on the discretionary services it provides, and we have delayed case processing for all civil, non-urgent family law, and probate cases. What does this mean for the public?

Health and wellness checks are delayed for Conservatees, a segment of one of our most vulnerable populations;

Our clerk's offices are open to the public for far fewer hours;

We have very limited clerks staffing the windows for service to the pubic;

Lines are long, and the wait can last for hours;

As a result of the long lines we have witnessed altercations and unpleasant experiences have occurred while people vie for position to get to the front of the line;

Child custody mediation sessions are delayed. These are often highly inflammatory cases, where there is an urgency to obtain court orders. Parents must wait more than nine weeks to schedule a mediation session;

Legal information workshops and legal assistance services have been dramatically reduced for litigants with divorce, child custody, child support, and small claims cases;

Parties calling our small claims advice line must wait days – and sometimes months for advice;

Final divorce orders are delayed. Parties have to wait more than four months to get copies of their final divorce orders.

Without the use of our one-time fund reserves, our court would have already shut down vital services to the public. It is only with careful planning regarding the use of our one-time reserves that our court has managed to stay afloat this fiscal year.

The dismal forecast for the coming fiscal year is that we will be forced to drastically reduce even more services to the public. Although we will consult with the public and our justice partners before taking action, our court is now considering:

Prioritizing criminal and juvenile law cases over all others, resulting in delays in hearing all other case types;

Closing one of our courthouses, which will mean a great inconvenience and additional cost to litigants, as well as a delay in services.

Suspending adjudication of all small claims and limited jurisdiction civil cases;

Eliminating court reporters in civil cases.

Efforts have been made to find new revenue sources to support the courts. The Governor's proposal to increase civil fees by $50 million may result in a restoration of $1 million to our court's budget, but Contra Costa Superior Court would still be left with $5.2 million to cut in fiscal year 2012-13.

As the third branch of government, courts have a constitutional responsibility to provide access to justice for all those who seek it. But without the adequate support staff that we cannot process court filings, manage the associated cases, keep the parties informed of their upcoming hearings, or send judgments that have been rendered in a particular case.

Clearly, something must give. Contra Costa Superior Court has endeavored to employ a proactive approach to absorb each of the financial blows we have been dealt – but now we are now faced with more than we can absorb without severely compromising our ability to fulfill our constitutional mandates. Our ability to provide meaningful access to justice when people need it will be diminished. "Justice delayed is justice denied."

Related content:

A Budget That Could Cause a Broken Heart[10] – Kiri Torre, Contra Costa County Superior Court CEO, Contra Costa Lawyer, February 1, 2012

Presiding Judge Diana Becton's State of the Court[11] presentation, expanding on the looming budget cuts and community outreach programs that are in danger of being eliminated in the process, January 2012

CCCBA Joins Effort to Support Funding the Courts[12] – news release and photos from the "Stand up for Justice" rally on April 18, 2012 in San Francisco.

[10] http://cclawyer.cccba.org/2012/02/a-budget-that-could-cause-a-broken-heart/
[11] http://youtu.be/Ek2LPic2oD8
[12] http://www.cccba.org/attorney/news/press-20120315.php

Keeping A Slice Of The Pie For Yourself: Exempting IRAs, 401Ks And 529 Plans

Friday, June 1, 2012

When a debtor files for bankruptcy relief, an estate is created. 11 U. S. C. §541(a)[1][13] provides that the estate consists of all legal and equitable interests of the debtor in property as of the filing date. Section 522 then allows a debtor to exempt (or protect from creditors) certain property from his or her estate depending on his residence. Congress conferred upon the states very limited authority to legislate in the bankruptcy area. Section 522(b)(1) gives narrow authority to the states to either accept or reject the use of the federal bankruptcy exemptions found in section 522(d) by either opting in or out of the federal exemptions. California is one of the states that has opted out of the federal exemption scheme. See California Code of Civil Procedure ("CCP") §703.130. As such, except in cases in which a debtor has not resided in California for the 730-day period prior to the bankruptcy filing, California bankruptcy debtors must rely on the exemptions set forth in either CCP §§ 703.140 or 704.010 et seq. Therefore, except as expanded by the Bankruptcy Abuse Prevention Consumer Protection Act of 2005 ("BAPCPA"), discussed below, debtors in bankruptcy generally receive the same protection from creditors available to California debtors who do not file bankruptcy.

Individual Retirement Accounts (IRAs)

IRAs are exempt for California debtors under either CCP §§ 703.140(b)(10)(E) or 704.115(a)(3). CCP §703.140(b)(10)(E) allows a debtor to exempt "[a] payment under a stock bonus, pension, profit sharing, annuity, or similar plan or contract on account of illness, disability, death, age or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor". Courts have wide discretion in determining what is "reasonably necessary" but generally rely on what is referred to as the Moffat factors: (1) the debtor's present and anticipated living expenses and income; (2) the age and health of the debtor; (3) the debtor's ability to work and make a living, including his/her training, skills and education; (4) the debtor's ability to save for retirement;

[13] #_ftn1

and (6) any special needs of the debtor and his/her dependents. *In re Moffat*, 119 B. R. 201 (9th Cir BAP 1990). CCP §704.115(a)(3) has a similar "reasonably necessary" requirement.

In 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act ("BACPA") and among the revisions to Title 11 (better known as the Bankruptcy Code) is a provision expanding the protection of retirement funds even if the debtor's state has opted out of the federal exemption scheme. Section 522(b)(3) allows debtors to exempt "retirement funds to the extent those funds are in a fund or account that is exempt from taxation under §§ 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986." For purposes of this article, those IRS Code sections include traditional, Roth and SEP IRAs. 26 U. S. C. §408(e)(1) recognizes that "any individual retirement account is exempt from taxation under this section …" As such, California debtors in bankruptcy are no longer limited to the CCP exemptions but may independently claim the section 522(b)(3) exemption. Congress intended to preempt conflicting state exemption laws and to expand the protection for tax-favored retirement plans that may not have been protected under state law. A debtor's right to exempt retirement funds under section 522(b)(3)(C) now prevails over any conflicting state exemption laws.

Section 522(b)(4) then lists the following two ways retirement funds are exempt for purposes of Section 522(b)(3)(C):

First: "if the retirement funds are in a retirement fund that has received a favorable determination under section 7805 of the Internal Revenue Code of 1986, and that determination is in effect as of the date of the filing of the petition in a case under this title, those funds shall be presumed to be exempt from the estate."

Second: "if the retirement funds are in a retirement fund that has not received a favorable determination under such section 7805, those funds are exempt from the estate if the debtor demonstrates that (i) no prior determination to the contrary has been made by a court or the Internal Revenue Service, and (ii) (I) the retirement fund is in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986; or (II) the retirement fund fails to be in substantial compliance with the applicable requirements of the Internal Revenue Code of 1986 and the debtor is not materially responsible for that failure."

Section 522(b) imposes a cap of $1,171,650 on the aggregate value of assets that an individual debtor may claim as exempt under section 522(b)(3)(C) in IRAs established under either Sections 408 or 408A of the Internal Revenue Code. Certain exceptions apply including a simplified employee pension account (408(k)) or a simple retirement account (408(p)). Further the dollar limitations do not apply to amounts in the IRA that are attributable to rollover contributions, for example, from a previous 401K plan, and any earnings thereon. The dollar amount increases every three years to adjust for inflation. The next adjustment occurs April 1, 2013.

Section 522 also covers direct transfers and rollover distributions. Subsection (b)(4)(C) states that a direct transfer of retirement funds between tax exempt accounts does not affect the exemption status. Similarly, subsection (b)(4)(D) provides that a properly rolled-over distribution does not affect the exemption of the distribution. As such, retirement funds like IRAs that are properly transferred via direct transfer or a tax-free rollover distribution can still be exempted. Debtors should review their IRA accounts, including all distributions and rollovers, to be sure they are in proper compliance and exempt from taxation under the applicable sections of the IRC. See *In re Patrick*,411 B. R. 659 (Bankr. C. D. Cal. 2008) (finding that improper rollovers were not exempt from the bankruptcy estate).

An issue that has been working its way through the courts has been whether a debtor can exempt an inherited IRA. The Ninth Circuit Bankruptcy Appellate Panel recently ruled in favor of the debtor in *In re Hamlin*, 465 B. R. 863 (9th Cir. BAP 2012). In that case, the Chapter 7 trustee objected to the debtor's exemption on the grounds that an inherited IRA was not funded by the debtor and therefore not exempt. Debtor's mother had funded an IRA of approximately $32,000 and shortly after her death, debtor transferred the funds via a trustee-to-trustee transfer. The debtor argued that Congress intended to expand the protections of IRAs including trustee-to-trustee accounts (See *In re Tabor*, 433 B. R. 469 (Bankr. M. D. Pa 2010) while the trustee argued that Congress only intended IRA protection for those who earned the funds (See *In re Chilton*, 426 B. R. 612 (Bankr. E. D. Tex 2011). In adopting the debtor's argument, the Hamlin court noted that Section 522 does not specify that it must be the "debtor's" retirement funds and that the funds were originally contributed by the account holder as retirement funds and retained that status when transferred per a trustee-to-trustee transfer. IRC Section 408(e) provides that "any" IRA is exempt from taxation and so the Hansen court interpreted that to not only include traditional IRAs but also inherited IRAs as they are expressly referenced in IRC Section 408(e)(3)(C)(ii). Beneficiaries of inherited IRAs cannot treat the inherited IRA as their own – they cannot make contributions or rollover any amounts into or out of the account. Note that a different result would occur if the debtor withdrew the funds pre-petition and then attempted to claim those funds as exempt.

401Ks

Many debtors have some interest in a 401K when they file for bankruptcy relief. Section 541(c)(2) excludes from property of the estate any property that is held in trust and subject to restriction on transfer under applicable nonbankruptcy law. 401Ks are ERISA qualified plans that contain "applicable nonbankruptcy law" restrictions on alienation and are excluded from the bankruptcy estate. *Paterson v. Shumate*, 504 U. S. 753 (1992). As such, 401Ks are fully exempt from a bankruptcy trustee's or creditor's reach.

529 Plans

Section 529 plans are popular educational savings plans for those with children going to college. They can either be a pre-paid tuition plan or a college savings plan. They have tax advantages as the earnings are not subject to federal tax and in most cases, state tax, so long as the withdrawals are used for applicable college expenses like tuition and room and board.

When a debtor files for bankruptcy relief, section 541(b)(6) excludes from property of the bankruptcy estate "funds used to purchase a tuition credit or certificate or contributed to an account in accordance with section 529(b)(1)(A) of the Internal Revenue Code of 1986 under a qualified State tuition program (as defined in IRC Section 529(b)(1) of such Code) not later than 365 days before the date of the filing of the petition". See *In re Bourguignon*, 416 B. R.745 (Bkrtcy. D. Idaho 2009) (holding that the relevant time period is more than 365 days for the funds to be considered not property of the estate) Further, the funds are only exempt if the designated beneficiary was a child, stepchild, grandchild, or stepgrandchild of the debtor for the taxable year when the funds were deposited into the account and the aggregate amounts paid to programs for the same beneficiary do not exceed the contribution limits as set forth in IRC section 529(b)(6) with respect to the beneficiary. Finally, funds placed in the accounts between 365 and 720 days before the bankruptcy filing are limited to $5,580 for each designated beneficiary's accounts but there is no limitation on the exclusion for funds that were contributed more than 720 days before the bankruptcy filing. The *Bourguignon* court noted that third party (non-debtor) contributions to the account do not make a difference with regard to the amount that is exempt since section 541(b)(6) focuses on the timing of the contributions and not the source of the contributions. As such, debtors should consider all contributions to the 529 account pre-petition rather than just their own contributions.

Conclusion

Based upon the protections afforded to retirement accounts under state law, as well as within the context of filing for protection under the Bankruptcy Code, the use of retirement funds by debtors to pay their creditor should, in most cases, be avoided.

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[1] Unless otherwise stated, all statue references are to sections of the Bankruptcy Code at 11 U. S. C. et seq.

Proprietor Beware: Corporate Refuge Can Ensnare

Friday, June 1, 2012

In theory at least, business owners incorporate (or form similar entities) to limit personal risk. However, these precautions mostly don't affect tort exposures like negligence (hence, one still needs insurance), and the touted benefit is nil if the principal blithely guaranties the company's significant obligations. Worse, the extra structural layer can cause mischief beyond pointless red tape: If the business fails and oppressive debt flows through, the shareholder can face more grief than a sole proprietor would.

Below we touch on several such pitfalls. As explained, financially distressed (sole?) proprietors likely have better protection on debts secured by real estate, they have more leeway to use scarce resources for personal needs, and they are probably freer to decide which debts to pay first. While the corporate form can also have countervailing advantages (with or without buffered liability), weighing the pros and cons likely requires 20/20 hindsight.

No Trust Deed Shields

Many California lawyers know that three's often a crowd in borrowing against real property. When a loan is secured by realty, the state's "one form of action" and antideficiciency rules afford a measure of insulation for those whose performance is backed by the mortgage or deed of trust. *See* Cal. Code Civ. Proc. ("CCP") §§ 580d, 726. On default, the lender cannot merely sue for breach of a promissory note, but must either resort to a cumbersome judicial foreclosure action or elect nonjudicial foreclosure under a power of sale. The latter is far more common in practice, and a trust deed beneficiary who takes that route forfeits contractual recourse to the trustor-borrower for any shortfall in the foreclosure proceeds. Thus, if I use my own land as security and things go sideways, I can easily lose the property, but (assuming no sold-out junior liens) I probably won't face residual claims against unencumbered assets or my future earnings.

The plot thickens if my corporation owns the building and borrows the money, but—as is typical—the bank insists on my guaranty, fortified by all that boilerplate text disavowing suretyship defenses. *See* Cal. Civ. Code

("Civ.") § 2856 (validating expansive waivers). Assuming the guaranty is unsecured and genuine (not a sham contrived to defeat the trust deed financing constraints, *see Union Bank v. Brummell*, 269 Cal. App. 2d 836, 838 (1969)), my failure to honor a proper demand means the bank can immediately sue for breach—no need to look to the security first or to struggle through judicial foreclosure. *See Martin v. Becker*, 169 Cal. 301, 306-307 (1915). Further, even if the bank begins with a nonjudicial foreclosure, the guaranty's standard "*Gradsky*" waiver means I'll have no antideficiency armor. *GlendaleFed. Sav. & Loan Ass'n v. Marina View Heights Dev. Co.*, 66 Cal. App. 3d 101, 154 (1977). In other words, at least from this perspective, I've outsmarted myself in choosing to borrow via the corporation.

Personal Asset Use as Fraudulent

Transfers to hinder, delay, or defraud creditors are improper, and – even if intent is benign – an insolvent's transfer for less than reasonably equivalent value in exchange is voidable. *See* Civ. §§ 3439-3439.08. However, as a proprietor on the ropes, I could still presumably use business revenues to meet my own living expenses, because the money belongs to me, and buying groceries wouldn't readily be cast as a fraud on creditors even though it would deplete my leviable assets.

But if I've incorporated the business, I'm just the stockholder, and the company can only make distributions on account of equity if it can cover its debts. *See* Cal. Corp. Code §§ 500, 501. In using cash to buy my groceries, I'm initially making a transfer from the corporate coffers to myself and—positing that the company is insolvent—this would be improper and at least constructively fraudulent unless I'm contributing reasonably equivalent value in exchange. While I might be providing services for which a fair wage is appropriate, that's a question of fact (and there's also the extra freight of payroll taxes to consider). If I'm not currently working for the company, then drawing dollars out to support my family may be pretty dicey.

A misstep here could have serious consequences. Improper distribution would effectively siphon off funds reserved for creditors and—if considered a "willful and malicious injury" to another's property, within the meaning of 11 U. S. C. ("BK") § 523(a)(6)—my liability could be excepted from any discharge I get through personal bankruptcy. *See Nahman v. Jacks (In re*

Jacks), 266 B. R. 728, 740-43 (Bankr. 9th Cir. 2001). Still more foreboding, a determination that I took corporate funds knowing this would prejudice creditors could establish that I *intended* to hinder, delay, or defraud them. If both the company and I then wind up in bankruptcy within a year thereafter, my entire personal discharge could be denied as a result. *See Redmondv. Karr (In re Karr)*, 442 B. R. 785, 796-98 (Bankr. D. Kan. 2011) (applying BK § 727(a)(7)). Again, by contrast, a proprietor consuming funds for food and rent would face no comparable jeopardy.

Restraint on Preferential Payments

Outside the bankruptcy context, debtors generally can pay valid claims in whatever sequence they choose, even when there's not enough to go around, *see* Civ. § 3432, and this ordinarily wouldn't constitute a fraudulent transfer. *See Wyzard v. Goller*, 23 Cal. App. 4th 1183, 1188-91 (1994). However, once a corporation is insolvent, California recognizes a "trust fund doctrine" whereby the company's assets are held for the benefit of all creditors, and management mustn't pay insider claims preferentially. *See Commons v. Schine*, 35 Cal. App. 3d 141, 144-45 (1973). There is even authority suggesting that an officer may be liable for preferring an outsider. *See Saracco Tank & Welding Co. v. Platz*, 65 Cal. App. 2d 306, 315-16 (1944).

So suppose that the creditors of my failed enterprise include my brother, a bank that says my loan application was misleading (so that this debt could be bankruptcy-resistant under BK § 523(a)(2)), and several vendors with whom I hope to do business again in a future venture. As a proprietor, there's little doubt that I can choose to pay these debts first (thereby forestalling family feuds, curtailing a potentially nondischargeable exposure, and keeping faith with those prospective suppliers), and the transfers will stick unless I'm in a bankruptcy within the "preference" reachback window (a full year for my "insider" sibling, but in this setting only 90 days for the bank or the vendors). *See* BK § 547(b)(4).

Now suppose the business is incorporated and the trust fund doctrine is triggered. As the guy in charge, I almost certainly couldn't pay my own claims ahead of others, and in favoring my brother, the bank, and key vendors, I would do much the same thing—I would pick them to maximize the personal benefit I get from satisfying their claims first. Thus, a California court might well say I’m personally liable to the disadvantaged creditors for the funds so diverted.

But, so what? If I was already obliged on guaranties, or if I would have been directly bound anyway as a proprietor, aren’t we dealing with the very same debt? Not necessarily: Some cases hold that—as a *trustee* of the insolvent company’s assets who disbursed them preferentially—I would have committed “defalcation” in a fiduciary capacity, and that could easily make any resulting liability nondischargeable in my personal bankruptcy. *See Nahman v. Jacks (In re Jacks)*, 266 B. R. 728, 736 (Bankr. 9th Cir. 2001) (citing BK § 523(a)(4)). In other words, at least to the extent of the same strategic preferences I could have conferred with impunity as a proprietor, I may now have saddled myself with unshakable debt. *But see Swimmer v. Moeller (In re Moeller)*, No. 11-90207-LT, 2012 Bankr. LEXIS 1202 (Bankr. S. D. Cal. Mar. 5, 2012) (trust fund doctrine doesn’t create express or technical trust required for defalcation liability).

Upside Offsets

Of course, the corporate form can have advantages apart from redirecting liability. Some examples:

While there’s no obvious, legitimate way to shield proprietorship cash from a judgment creditor, the company could properly pay me a reasonable wage for services rendered, and the regular 25% garnishment limit should apply to those earnings. CCP § 706.050 (incorporating disposable earnings restriction of 15 U. S. C. § 1673(a)); *cf. Carter v. Anderson (In re Carter)*, 182 F.3d 1027 (9th Cir. 1999) (CCP § 704.070‘s correlative 30-day exemption for 75% of paid earnings traceable into deposit account is available to sole director-shareholder of “S” corporation).

Similarly, although California only recognizes a qualified exemption—covering amounts “necessary” for the debtor and dependents’ projected future “support”—as to a self-employed retirement plan or an individual retirement account, *see* CCP § 704.115(e), funds held in a plan sponsored by my close corporation should be fully exempt, even though I *am* the company. *See Cheng v. Gill (In re Cheng)*, 943 F.2d 1114, 1116-17 (9th Cir. 1991). (This benefit is currently less important if I file personal bankruptcy, since I can likely exempt $1,171,650 in IRA or Keogh funds under BK § 522(b)(3)(C) and (n).)

If my proprietorship is still "kicking" but has little or no sale value, I might want to pursue a simple chapter 7 discharge while continuing the business, perhaps my only source of income. Unfortunately, a chapter 7 debtor can't use estate assets for ongoing operations. *See In re Gracey*, 80 B. R. 675, 678 (E. D. Pa. 1987), *aff'd*, 849 F.2d 601 (3d Cir.), *cert. denied*, 488 U. S. 880 (1988). And because chapter 7 trustees are responsible for estate property and obliged to liquidate it expeditiously, *see* BK § 704(a)(1)-(2), they usually demand that all business activity cease (though a trustee theoretically could operate with leave under section 721). However, if I've incorporated and the company doesn't file bankruptcy, my own chapter 7 petition needn't disrupt the enterprise (and the trustee would rarely give a hoot unless my stock had unencumbered, nonexempt value). (Note, though, that an eve-of-bankruptcy incorporation is hazardous if it harms creditors. *SeeEmmett ValleyAssocs. v. Woodfield (In re Woodfield)*, 978 F.2d 516 (9th Cir. 1992) (discharge denied for fraudulent intent).)

Upshot?

Only clairvoyance could foretell up front how all this will play out if a business falters. However, inasmuch as incorporation plainly could backfire, and since an artificial entity inherently complicates life, most folks probably should remain sole proprietors unless there's good reason to depart from the basic model. Given that sophisticated creditors frequently require a guaranty anyway, the imagined escape from personal exposure in and of itself probably doesn't justify incorporating for the average small fry.

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Family Law Attorneys Beware: Possible Exceptions to The Chapter 7 Bankruptcy Discharge

Friday, June 1, 2012

Marlene Weinstein

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (hereinafter "BAPCPA") enacted on April 20, 2005, and generally applicable to all cases filed on or after October 17, 2005, made various revisions to Title 11 of the United States Code (hereinafter "Bankruptcy Code") with regard to divorce-related debts. For example, debts such as child and spousal support were given the new classification of "domestic support obligation" and were given added protection.

Although child and spousal support obligations and other debts which were determined to be "in the nature of support" were nondischargeable pursuant to 11 U. S. C. §523(a)(5) prior to BAPCPA, regardless of whether a Debtor filed for protection under Chapter 7[1][14], 11[2][15], 12[3][16] or 13[4][17] of the Bankruptcy Code, the same was not true of other types of divorce-related debts such as a hold harmless obligation, an equalizing payment and/or a debt based upon the Debtor's breach of a fiduciary duty, fraudulent representation and/or willful and intentional conduct (hereinafter "Non-Support Debt").

Prior to BAPCPA, a Non-Support Debt was dischargeable if a Debtor filed for protection under Chapters 13 and received a Chapter 13 discharge. However, if the Debtor filed a Chapter 7, 11 or 12 bankruptcy case, the Non-Support Debt was discharged UNLESS a spouse, former spouse or child of the Debtor (hereinafter collectively "Spouse") was successful in asserting that the Debtor's obligation to the Spouse for the Non-Support Debt should be excepted from discharge on any of the following grounds – misrepresentation or fraud [§523(a)(2)]; breach of fiduciary duty [§523(a)(4)]; willful or malicious injury [§523(a)(6)]; and/or that "the debt was incurred by the debtor in the course of a divorce or separation in connection with a separation agreement, divorce decree or other order of a court of record …" [§523(a)(15)][5][18]. However, unless the Spouse filed a lawsuit against the Debtor in Bankruptcy Court within sixty (60) days of the first date set for the meeting of creditors[6][19] and prevailed against the Debtor in the lawsuit, with the exception of §523(a)(5) debts, a Debtor's obligations to his/her Spouse were discharged and the Spouse was forever barred from seeking collection of the debts from the Debtor. With the enactment of BAPCPA, the rules changed. Pursuant to the provisions of BAPCPA, a Debtor who now files a Chapter 13 case and receives a Chapter 13 discharge will still receive a discharge of a Non-Support Debt incurred in connection with a divorce or separation that might have been excepted from discharge in a Chapter 7 case prior to BAPCPA pursuant to 11 U. S. C. §523(a)(15), such as a hold harmless obligation and/or an equalizing payment.

However, if the Non-Support Debt is one that might be excepted from discharge because the debt was incurred based upon the Debtor's misrepre-

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sentation or fraud under Section 523(a)(2), or the Debtor's breach of fiduciary duty under Section 523(a)(4), then such a debt can be excepted from the discharge in a Chapter 13 case pursuant to post-BAPCPA 11 U. S. C. §1328(a)(2). However, just like in the pre-BAPCPA Chapter 7 cases, the Spouse would have to file a complaint against the Debtor within sixty (60) days after the first date set for the meeting of creditors in the Chapter 13 case and prevail against the Debtor in the complaint.

Pursuant to the provisions of BAPCPA, a Debtor who now files a Chapter 7 case and receives a Chapter 7 discharge does not receive a discharge of any debts incurred in connection with a divorce or separation, etc., even those debts that might otherwise have been dischargeable prior to BAPCPA pursuant to 11 U. S. C. §523(a)(15). There is no longer a balancing test for debts such as hold harmless obligations and equalizing payments — they are not dischargeable by the Chapter 7 discharge. In addition, debts incurred in connection with a divorce or separation that were incurred based upon the Debtor's misrepresentation or fraud and/or breach of fiduciary duty pursuant to Sections 523(a)(2) and/or (a)(4) that required the filing of a complaint in the Chapter 7 case to obtain an order that such debts are nondischargeable no longer require a Spouse to file a complaint in the Chapter 7 case to be nondischargeable.

HOWEVER, there may be a glitch. Assume the following facts with respect to a Spouse's claim against the Debtor for a breach of fiduciary duty based upon the Debtor's unauthorized and post-separation disposition of his/her retirement account:

Assume the Debtor files a Chapter 7 case. The debt is nondischargeable as a Non-Support Debt based upon the fact that it is a debt incurred in the course of a separation and/or a divorce pursuant to 11 U. S. C. §523(a)(15).

Assume that the debt is also likely to be nondischargeable as Non-Support Debt that is based upon the Debtor's breach of fiduciary duty under 11 U. S. C. §523(a)(4). However, because the Spouse knew the debt was nondischargeable without taking any action under Section 523(a)(15), the Spouse decided not to spend any money filing a complaint against the Debtor in the Bankruptcy Court, and therefore, the Spouse never filed the complaint in the Chapter 7 case that is required to be filed within the 60-day period following the meeting of creditors in order to obtain a determination by the

Bankruptcy Court that the Debtor breached his/her fiduciary duty and that the debt is nondischargeable, not only pursuant to Section 523(a)(15), but also pursuant to 11 U. S. C. §523(a)(4).

Several years later, the Debtor files a Chapter 13 case. As stated above, all Non-Support Debts will be discharged in the Chapter 13 case unless it is nondischargeable based upon 11 U. SC. §§ 523(a)(2) and/or (a)(4).

The only Non-Support Debt that was excepted from the Chapter 7 discharge was the divorce-related debt under 11 U. S. C. §523(a)(15) since there will be discharged in the Chapter 13 case.

Based upon the foregoing facts, it is likely that the Debtor will take the position, and this writer believes that the Bankruptcy Court will agree, as follows:

That the Non-Support Debt that was excepted from the Chapter 7 discharge was nondischargeable pursuant to 11 U. S. C. §523(a)(15) only;

That the Spouse waived his/her right to assert that the debt arising out of the Debtor's breach of fiduciary duty is nondischargeable pursuant to 11 U. S. C. §523(a)(4) due to the fact that the time to raise that issue was sixty (60) days after the first date set for the meeting of creditors in the Chapter 7 case;

That since the Spouse failed to file the complaint in the Chapter 7 case within the requisite deadline, that the only Non-Support Debt that survived the Chapter 7 case was the debt incurred in connection with a separation and/or a divorce pursuant to 11 U. S. C. §523(a)(15); and,

Therefore, the debt will be discharged in the Debtor's Chapter 13 case.

The foregoing is an attempt to bring to the attention of both family law and bankruptcy attorneys, the necessity of discussing all of the issues that arise with respect to the dischargeability of a divorce-related debt that is a Non-Support Debt, so that a Spouse can make an informed decision as to whether or not to rely on the Chapter 7 discharge to preserve his/her rights against the Debtor.

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[1] Chapter 7 discharge provided by 11 U. S. C. §727.
[2] Chapter 11 discharge provided by 11 U. S. C. §1141.
[3] Chapter 12 discharge provided by 11 U. S. C. §1228.
[4] Chapter 13 discharge provided by 11 U. S. C. §1328.
[5] Cases interpreted the provisions of Section 523(a)(15) in a variety of ways since its passage in October, 1994; however, whether a debt incurred in the course of a divorce or separation, etc. would be discharged required the court to determine either (A) that the debtor did not have the ability to pay the debt or (B) that discharging the debt would result in a benefit to the debtor that outweighed the detrimental consequences to the spouse, former spouse or child of the debtor.
[6] See Federal Rule of Bankruptcy Procedure 4007(c).

Lien Strip Basics and the Evolving Law on "Chapter 20"

Friday, June 1, 2012

Steven T. Knuppel

With the advent of the housing crisis, many homeowners find themselves owing a great deal more on their property than it is worth. Under the right facts, a "lien strip" can provide relief to such homeowners.

Lien strips are not allowed in Chapter 7 bankruptcy.[1][20] However, despite language in 11 U. S. C. §1322(b)(2) which precludes the modification of a claim secured only by a security interest in real property that is the debtor's principal residence, the Ninth Circuit has ruled that lien strips are allowed with respect to a debtor's principal residence in Chapter 13 cases.[2][21] This difference has emerged as one of the primary reasons that a debtor might choose Chapter 13 over Chapter 7.

[20] #_ftn1
[21] #_ftn2

Although lien strips are also allowed in Chapter 11 cases, Chapter 11 cases are generally not available to the average debtor – not only because of the cost involved, but also due to additional requirements including, but not limited to, the fact that creditors have a right to vote on the plan. Therefore, debtors have attempted to use the so-called “Chapter 20” cases to strip liens in situations where they are not eligible to file Chapter 13 initially due to unsecured debt exceeding the statutory limitation, which is currently $360,475.

In reality, there is no such thing as a Chapter 20; rather it is jargon referring to the situation in which a debtor files a Chapter 7 bankruptcy followed by a Chapter 13 bankruptcy. [3][22] By filing a Chapter 7 bankruptcy first and obtaining a discharge of general unsecured debt, the debtor can reduce unsecured debt to less than $360,475, and then be eligible to file Chapter 13. [See further discussion below]

This article will describe the basics of what a lien strip is and how you proceed. It will also examine the evolving law concerning the availability of lien strips in so-called “Chapter 20” cases.

What is a lien strip?

The term “lien strip” is colloquially used by bankruptcy practitioners to refer to several different situations.[4][23] In this article, we are talking about removal of junior deeds of trust that are “underwater”, i.e, the amount of any senior liens exceed the fair market value of the real property. The procedure by which this is accomplished is formally known as a “Motion to Value Security” and is based upon 11 U. S. C. §506.

In order to strip a junior lien on a primary residence, the junior lien must be completely out of money. If there is any value to secure any portion of the junior lien, then lien stripping is not available. For example, let’s say that the value of the Debtor’s residence as reflected in the bankruptcy papers filed by Debtor is $450,000. The lender holding the first position deed of trust is owed $500,000. The lender holding the second position deed of trust has a claim in the amount of $100,000. In this scenario, upon a proper showing, the Debtor will be able to obtain a lien strip order regarding the second deed of trust.

[22] #_ftn3
[23] #_ftn4

However, if we change the foregoing hypothetical by placing the value of the residence at $525,000, the result would be different. The second deed of trust is now secured by $25,000 of value. Although this amount is less than the full amount of the claim, it is enough to defeat a motion to strip the junior lien.

How to Proceed

In order to strip a lien, the debtor must affirmatively do something. Although the plan must provide for the lien strip (if a lien strip is desired), a lien is not stripped just because one's bankruptcy plan provides for it. The debtor must also seek an order from the court providing the desired relief. How is this done?

First of all, make sure the Court has the jurisdiction to grant you the relief you need. As stated above, the procedure is based upon 11 U. S. C. §506 which refers to the determination of secured status and provides, in part, "An allowed claim of a creditor secured by a lien on property in which the estate has an interest, …. is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, …" The Oakland bankruptcy judges have all taken the position that the property at issue must be property of the bankruptcy estate at the time the motion and/or the adversary proceeding seeking to value the security is filed.

Another jurisdictional issue to consider in planning whether and how to file a Chapter 13 case to strip a lien is whether the Bankruptcy Court has jurisdiction over the property to do so. For example, if title to the real property is held in joint tenancy, both joint tenants must file the bankruptcy in order for the Court to have jurisdiction over the entire property. If only one of the joint tenants files bankruptcy, the junior lien can only be stripped from the one-half of the real property that became property of the bankruptcy estate. The half of the property belonging to the non-filing joint tenant is still encumbered by the junior lien and therefore, the property cannot be sold without paying off the junior lien. It is unclear whether the lien could be stripped at all, and what the ramifications would be if the non-filing joint owner fails to make the ongoing payments.

If you decide the Court has the necessary jurisdiction and you are ready to proceed, you will need to consult local practice. There is a great deal of local variation in bankruptcy practice. Therefore, a great place to start with any bankruptcy issue is the bankruptcy court website[24] for the relevant district for the local rules and any published guidelines on your topic. For example, the guidelines published by the Bankruptcy Court in the Northern District of California are particularly good and there is an immensely helpful set of guidelines for practitioners on how to proceed with lien strips. See Northern District of California Bankruptcy Court, *Guidelines for Valuing and Avoiding Liens in Individual Chapter 11 Cases and Chapter 13 Cases* (Sept. 9, 2010) at `http://www.canb.uscourts.gov/procedures/dist/guidelines/`. The Guidelines there provide information on required papers, setting hearings, proposed orders, and more.

Nationally, there is some debate about the proper procedure for stripping a lien. May one file a motion or must one file an adversary proceeding complaint (a separate lawsuit within the bankruptcy proceeding)? In the Northern District of California, at least, the Court has issued guidelines allowing debtors to pursue "lien strips" *via* motion. The lien strip is often a critical component in making a Chapter 13 plan feasible, and, therefore, the motion should be brought and the order obtained early in the case, before confirmation. Local guidelines generally require entry of an order valuing the security prior to confirmation of a Chapter 13 plan. [See Court guidelines[25], referenced above]

Giving proper notice is a critical requirement in obtaining an order on a Motion to Value Security.[5][26] The Debtor's attorney must be certain to provide proper notice of the motion to the affected lienholder in compliance with *Federal Rule of Bankruptcy Procedure* (FRBP) Rule 7004. In particular, where the lender is an FDIC insured institution, service must be made in compliance with FRBP Rule 7004(h). (Go to www.fdic.gov to find the proper address for service of federally insured lenders; if the lender is not insured, go to the California Secretary of State website to find an agent for service of process.)

When it comes to providing notice of a Motion to Value Security, it is better to err on the side of caution. Serve the motion not only on the address that you have identified with the FDIC or Secretary of State, but also on every address that the creditor may have provided to you in the bankruptcy case,

[24]`http://www.canb.uscourts.gov/procedures/dist/guidelines/`
[25]`http://www.canb.uscourts.gov/procedures/dist/guidelines/`
[26]`#_ftn5`

such as in connection with filing a Proof of Claim. Print and retain in the file hard copies of anything that will show why you served the motion at the addresses that you did on the date you served your motion. Addresses for service can change between the date of service and the date you request your order from the Court. Without evidence of proper service, upon a challenge by the lender, you may run into difficulty actually removing the lien after the plan has been completed, even if the Court grants your motion at the outset.

The End Game

Although an order is obtained near the beginning of the Chapter 13 case, the lien is not really removed until the debtor successfully completes the Chapter 13 plan, usually about five years later. The plan must provide that in the event the debtor's case is dismissed or converted without completion of the plan, the secured creditor retains its lien to the extent recognized by non-bankruptcy law. 11 U. S. C. § 1325(a)(5)(B)(i)(II).

So how does the lien actually come off of the property? Although there is a split of authority among jurisdictions regarding the proper procedure to follow (among the possibilities are an adversary proceeding, a contempt action or possibly a superior court action to quiet title), the Northern District has made it relatively simple. Its standard-form Order Valuing Lien, found in its Guidelines, provides that "upon application by Debtor, the court will enter an appropriate form of judgment voiding the Lien." The Guidelines also provide a standard-form Judgment Voiding Lien. Also, it is best to try to contact the creditor (some are easier to communicate with than others) to request a reconveyance of the deed of trust based upon the Judgment Voiding Lien having been entered. Some creditors will cooperate with this request.

Chapter 20 Bankruptcy and Lien Strips

As stated above, "Chapter 20" is jargon that refers to filing a Chapter 13 shortly after receiving a discharge in a Chapter 7 bankruptcy case. The debtor is generally ineligible to receive a discharge in the Chapter 13 case since it is usually filed within four years of receipt of the Chapter 7 discharge.[6][27] If there is no discharge, why would you want to file a Chapter 20 bankruptcy?

[27] #_ftn6

As noted above, one reason is because the debtor was not eligible to file Chapter 13 initially. Another reason may be that most Chapter 7 cases are short, lasting a matter of months. Although many debts are discharged in Chapter 7, some debts and some creditors' rights survive. After the Chapter 7 closes, the debtor loses the protection of the bankruptcy court and, to the extent creditors' rights survived the Chapter 7, creditors can resume collection activity.

By contrast, Chapter 13 cases are long, anywhere from three to five years. By filing a "Chapter 20" case and getting a plan confirmed, a debtor can extend the protection available in bankruptcy court for another three to five years to deal with surviving obligations (say, income tax arrearages) in an orderly manner by making monthly payments.

Because lien strips are not available in a Chapter 7 bankruptcy and no discharge is available in the Chapter 13 portion of a Chapter 20, the question arises whether you can strip a junior lien in connection with the Chapter 13 case which is part of a Chapter 20 bankruptcy? Jurisdictions across the country, and even in California, have been divided on this point. However, the answer in the Northern California district (at least for now) is yes. Moreover, the trend of authority may be moving in favor of allowing lien strips in Chapter 20 cases. Two new decisions have broken ground here in California in just the last few months.

The Northern District

The leading decision in Northern California is *In re Tran* (Bankr ND Cal. 2010) 431 B. R. 230, written by the Honorable Edward D. Jellen before he left the bench. *In Re Tran* holds that the ability to strip a lien in a "Chapter 20" case does not depend upon eligibility for a discharge, but rather upon the successful completion of the bankruptcy plan. However, an important limitation in the *Tran* case is that the case be filed in good faith. The Court found in *In Re Tran* that the debtor Tran was unfairly manipulating the bankruptcy system because she did not have an independent reason for filing the Chapter 13 case.[7][28] Rather, the debtor Tran had filed it solely to seek a lien strip that was otherwise unavailable under Chapter 7.

Although not controlling on courts in other districts or even on other bankruptcy judges in the Northern District, *In Re Tran* has been cited ap-

[28] #_ftn7

provingly several times as "persuasive" authority on this issue. [8][29] The Honorable Stephen L. Johnson of the San Jose Division of the Northern District has followed *In Re Tran* in a memorandum decision signed on March 10, 2011 in the matter of *In Re Garcia,* Case Number 10-55411 SLJ.

The Southern District

A battle seems to be brewing in the Southern District. In April 2010, in the case of *In Re Casey* (Bankr. S. D. Cal. 2010) 428 B. R. 519, the Honorable Peter W. Bowie held that lien strips were not available in the Chapter 20 context. Later in 2010, in the case of *In Re Hill* (Bankr. S. D. Cal. 2010) 440 B. R. 176, the Honorable Margaret M. Mann ruled in favor of allowing lien strips, specifically stating that she was "persuaded by *In Re Tran*." (However, she also seemed to indicate that the creditor may be entitled to receive payment on a pro rata basis with all other general unsecured creditors notwithstanding debtors' receipt of their Chapter 7 discharge.) In July 2011, Judge Bowie responded in *In Re Victorio*, (Bankr. S. D. Cal. 2011) 454 B. R. 759, holding that "debtors in a Chapter 20 case cannot 'permanently' avoid a wholly unsecured junior lien", which is to say, that lien strips are not available.

Although the *Victorio* case had fairly simple facts, Judge Bowie authored an exhaustive opinion of over twenty pages, seemingly mindful that this issue may be taken up by a higher court in the near future. In the meantime, practitioners in the Southern District face the quandary that the availability of lien strips in these cases depends upon which judge you draw, you do not know which judge you will draw until you file, and whether you want to file or not may depend upon whether a lien strip will be available.

The Central District

Until recently, the Central District might have been put down into the column of jurisdictions that do not allow lien strips in Chapter 20. The case of *In re Winitzky* (CD Cal., May 7, 2009) 2009 Bankr Lexis 2430, although an unpublished decision, had nonetheless managed to be cited numerous times for the proposition that lien strips are not allowed in Chapter 20 cases. However, in an as yet unpublished Central District decision just a few weeks ago, the contrary result was reached. (*In Re Darzian* (Bankr.

[29] #_ftn8

C. D. Cal., March 27, 2012). The really interesting thing about this development is that *In Re Winitzky* and *In Re Darzian* were both authored by the same judge, the Honorable Maureen Tighe, whose analysis in the *Darzian* case was influenced by the intervening decision of *In Re Tran*.

The Eastern District

On March 8, 2012, in the case of *Frazier v. Real Time Resolutions Inc.*, (No. 2:11 CV-00290-MCE), the Eastern District Court decided this issue in favor of allowing Chapter 20 lien strips. This decision, too, relied upon *In Re Tran*, calling it "persuasive." Moreover, unlike the other decisions noted herein, this decision emanates from the district court level rather than from a bankruptcy judge. However, like Judge Mann in *In re Hill*, the Court stated the creditor would be entitled to receive a pro rata share of the distribution to general unsecured creditors notwithstanding debtors' receipt of their Chapter 7 discharge. See also the unpublished opinion of *In Re Eaton*, 2006 Bankr. LEXIS 4862 (9th Cir. BAP 2006).

Conclusion

Any of the foregoing could be swept away if a higher court addresses this issue, which would seem to be just a matter of time. The arguments of the opposing sides have been framed by *In re Tran* and *In re Victorio*. Although none of the three new judges in the Oakland Division have as yet been called upon to write an opinion on this issue**,** at least one judge in the San Jose Division has supported the analysis in *In Re Tran*. Thus, for now, lien strips appear to remain available to debtors in Chapter 20 in the Northern District. This will be good news for homeowners who continue to struggle through the Great Recession.

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[1] Lien strips are limited to reorganization cases (Chapter 11, 12 and 13). Lien strips are not available in Chapter 7 cases, which provide for a liquidation approach to bankruptcy. *Dewsnup v. Timm*, 502 U. S. 410, 417-20 (1992). Because Chapter 11 is not practical for the average debtor and Chapter 12 is available only for family farmers and fishermen, this article

focuses on Chapter 13 lien strips.

[2] *Zimmer v PSB Lending Corp(In Re Zimmer)* (9th Cir. 2002) 313 F.3d 1220, 1222-1225.

[3] *Frazier v. Real Time Resolutions Inc.* (E. D. Cal. 2012) March 8, 2012 (No. 2:11 CV-00290-MCE), p. 13.

[4] The term “lien strip” can refer to removal of judgment liens on real estate that impair a debtor’s exemptions. Also, a “lien strip” may occur on non-real estate assets, although the economics often do not justify seeking such relief. The term “lien strip” can refer to what is also known as “cramming down” a secured claim. That is, when a debt is only partially secured, for example, due to a drop in collateral value (say the debt is $100,000, but the collateral is worth $75,000), the claim can be broken into secured ($75,000) and unsecured portions ($25.000). There are a couple of catches: (1) you cannot cram on a principal residence; and (2) the secured portion of the debt has to be paid off entirely during the bankruptcy plan.

[5] ”[A] plan can effectively determine value and/or avoid a lien only if the creditor receives clear notice that the plan will do so.” *Shook v CBIC (In re Shook)* (BAP 9th Cir 2002) 278 BR 815, 824.

[6] 11 U. S. C. §1328(f)(1)

[7] *In Re Tran* was actually a single opinion addressing a common issue of law that arose in two unrelated Chapter 13 cases. The other debtor, Bennett, was not found to be manipulating the bankruptcy system and the judge overruled the objection to Bennett’s proposed lien strip.

[8] As mentioned in this article, the *In Re Tran* has been cited favorably by *Frazier v. Real Time Resolutions Inc; In Re Hill;* and *In Re Darzian.*. In addition, the *In Re Tran* decision was cited favorably at the Court of Appeals level by the Eighth Circuit in the opinion of *In re Fisette, 455* B. R. 177 (B. A. P. 8th Cir., 2011).

To file or not to file: How the timing of the bankruptcy can impact the exclusion of cancellation of indebtedness income

Friday, June 1, 2012

Mark Ericsson

In this era when homes are often worth less than the loans they secure and of dropping or nonexistent incomes, more and more people are forced to consider walking away from their homes. In a foreclosure or short sale, the banks holding the note and deed of trust will receive less than full value for their note. This gives rise to cancellation of indebtedness income. It has long been tax policy that when a debtor is released from a debt, that person has become wealthier and therefore realizes ordinary income to the extent of that increase of wealth. One of the driving forces in filing for bankruptcy is protection against taxes arising from cancellation of indebtedness income.

Since the concept of cancellation of indebtedness income is rooted in the theory that an increase in wealth results in income, taxpayers can exclude cancellation of indebtedness income to the extent the taxpayer is insolvent. This is because the taxpayer's creditors could have taken all the taxpayer's assets both before and after the cancellation of debt and there is no change in position. Since the taxpayer must prove insolvency, there is a degree of uncertainty in claiming the exclusion.

Bankruptcy provides a fresh start and in line with this philosophy, the cancellation of indebtedness income is automatically excluded. However, in both the insolvency and bankruptcy settings, there is a price to pay. Where the taxpayer emerges from bankruptcy with assets, the taxpayer must choose one of two ways to reduce the basis in those assets. In better days, the taxpayer was likely to emerge from bankruptcy with no assets and was thus unaffected by this rule. However, today, the taxpayer often emerges with property or tax attributes.

First, a taxpayer may elect to reduce the basis of his depreciable property by the amount of excludable income. For example, if the debtor owns a home that is worth $500,000 encumbered by a $500,000 mortgage and has credit card debt of $100,000, he or she may be allowed to keep the home. If the debtor purchased the home for $250,000, the basis will be decreased by the $100,000 in cancellation of debt income from the discharge of the credit card debt and the exclusion of the income. Upon sale, the $100,000 in reduced basis will be taxed at capital gains rates. The basis in bankruptcy estate assets is reduced first with any residual reduction applied against assets of the debtor.

If no election to decrease the basis of depreciable property is made, the taxpayer's attributes are decreased in the order set forth in the code. Net operating losses are first reduced by the amount of income that is excluded, followed by carryovers of business tax credits, carryovers of minimum tax credits, net capital loss carryovers, taxpayer's basis in property (which has its own ordering rule), passive loss carryovers and foreign tax credit carryovers. The credits are reduced one-third for each dollar of income. The attributes are determined at the date of the filing of the petition.

Under either regime, the decrease in basis occurs on the first day of the year following the exclusion. In the example above, if the taxpayer wants to sell the home, he has until the end of the year to sell the property to avoid the extra $100,000 in capital gain resulting from the reduction of basis.

The timing of the bankruptcy is important. If the home is lost to foreclosure before the bankruptcy, the taxable event has occurred and the taxpayer reports the cancellation of indebtedness income. If the tax was incurred within three years of the bankruptcy filing, the tax is non-dischargeable. The tax liability becomes a debt of the bankruptcy estate and if there are sufficient estate assets, may be satisfied by the estate.

A note and deed of trust has two elements. The note is a personal liability and that personal liability is discharged in bankruptcy. The deed of trust is a security interest and if not stripped may survive the bankruptcy. Therefore, if the short sale or foreclosure occurs during or after the bankruptcy, there will be no discharge of indebtedness income because the recourse debt has been discharged.

A reduction in basis generally converts today's cancellation of indebtedness ordinary income into tomorrow's capital gain. In weighing a discharge in bankruptcy against incurring cancellation of indebtedness income, the advantage today of capital gain over ordinary income is huge. However, this advantage will significantly diminish January 1 of next year if there is no intervening legislation. With the debate over the Buffet rule, there is discussion as to why capital gains should get a break at all. With so many variables, deciding whether to file a bankruptcy is not an easy equation.

Mark Ericsson practices taxation, business and estate planning law as a partner in the Walnut Creek firm Youngman & Ericsson, LLP[30], was the 2006 Contra Costa Bar Association president, and can be found at www.youngman.com.

[30] `http://www.youngman.com`

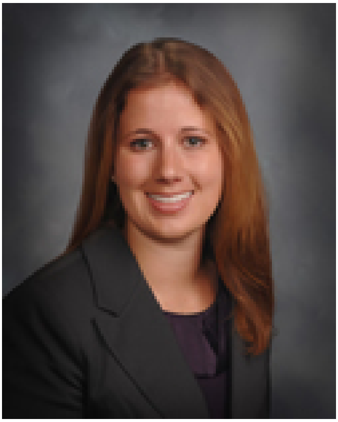
Unintended Consequences of Preliminary Agreements

Friday, June 1, 2012

Roger J. Brothers

When does a preliminary agreement become an enforceable contract? When does a "final proposal" become a binding agreement? How can parties be sure that memoranda of understanding exchanged during negotiations will not create enforceable, contractual obligations? In *First National Mortgage Company v. Federal Realty Investment Trust*[31], 631 F.3d 1058, (9th Cir. 2011) ("*First National*"), the Ninth Circuit Court of Appeals provided guidance, if not a blueprint, as to how to avoid having a preliminary agreement unwittingly become a binding contract. *First National* demonstrates the importance of including specific language in preliminary agreements and letters of intent that establishes their non-binding nature.

[31] http://www.ca9.uscourts.gov/opinions/view_subpage.php?pk_id=0000011186



Ericka L. Ackeret

First National involved the enforceability of a written agreement between a developer and a property owner. Federal Realty is a real estate investment trust that had plans to develop Santana Row, a mixed-use project in San Jose. As part of its development efforts, Federal Realty entered into negotiations with First National to acquire the property at issue in the case (the "Property"). The negotiations occurred over multiple years, and in 2000, the parties exchanged several proposals regarding the terms of a ground lease, including a "Counter Proposal," a "Revised Proposal," and finally a "Final Proposal," signed by both parties.

The Final Proposal is set forth in a single page, nine (9) paragraph, document, which

Dominic V. Signorotti

includes the rent amount, a “put” option in favor of First National, a “call” option in favor of Federal Realty, provisions regarding reimbursement and moving expenses, and a deadline by which the agreement must be accepted. The Final Proposal concludes with the statement that, “The above terms are hereby accepted by the parties subject only to the approval of the terms and conditions of a formal agreement.”

Following the exchange of the Final Proposal, the parties engaged in extensive, but ultimately unsuccessful, negotiations towards a formal agreement. During these negotiations, First National gave notice to vacate to its current tenant at the Property, and requested that Federal Realty reimburse it for any loss of rent. Federal Realty rejected this request, on the ground that no binding agreement was yet in place between the parties. Shortly thereafter, the negotiations fell apart and were terminated.

First National sued, alleging that Federal Realty committed an anticipatory breach of the Final Proposal. The district court, and eventually the court of appeal (the ”Court”), agreed with First National, and held that the Final Proposal did, in fact, constitute a binding and enforceable agreement, and on those grounds awarded the sum of $15.9 million in damages to First

National for lost rent over the term of the lease, and the loss of its "put" option.

At trial and during appeal, Federal Realty argued that the Final Proposal was conditional, and unenforceable to the extent that it was subject to the approval of a "formal agreement." The Court disagreed, and explained that an agreement is not rendered unenforceable merely because it is subject to the approval of a formal contract. Rather, the intent of the parties is the primary concern when determining whether an agreement is intended to be final or conditional.

The Court focused its attention on the specific and deliberate language of the Final Proposal, and noted that the parties' negotiations progressed from a "*Counter* Proposal," to a "*Revised* Proposal, and ultimately to a "*Final* Proposal." This, in the eyes of the Court, implied an intent to make the Final Proposal binding. In addition, the Final Proposal expressly provided that its terms "are *hereby accepted* by the parties *subject only to* approval of the terms and conditions of a formal agreement." Based on this language, the Court concluded that "it cannot be said, as a matter of law, that the Final Proposal was not meant to be binding." In doing so, the Court distinguished specifically the Final Proposal from a case in which the document at issue was titled "letter of intent," and which contained the express provision that "this letter of intent is of no binding effect." (See, *Rennick v. O. P. T. I. O. N. Care, Inc.* 77 F.3d 309 (9th Cir. 1996).) The Court observed further that the Final Proposal did not include a non-binding clause, which Federal Realty had included in its earlier drafts. Finally, the Court held that substantial evidence was presented at trial to support the jury's finding that both parties intended the Final Proposal to be an enforceable agreement.

First National should also be considered with respect to debtors in bankruptcy. Once a bankruptcy is filed, the Trustee may elect to assume any unexpired executory contract, thereby preserving the remaining benefits of the contract. When does a party have an "executory contract" with a debtor in bankruptcy? The Bankruptcy Code furnishes no express definition of "executory contract." (See, 11 U. S. C. §365(a).) However, the legislative history to §365(a) indicates that Congress intended the term to mean a contract "on which performance is due to some extent on both sides." (See, *N. L. R. B. v. Bildisco & Bildisco,* 465 U. S. 513 (1984).) However, as a result of the recent ruling in *First National,* one must be aware that a preliminary agreement, which does not contain non-binding language, may be deemed to constitute an "executory contract," and may therefore be assumed by a Trustee in bankruptcy. An executory contract may be sold and assigned by the Trustee to a third party, even though the contract has a provision which otherwise prohibits assignment. The non-debtor party to such a contract, or preliminary agreement, may find itself in the often risky position of having to continue to do business with a bankruptcy estate or a third party with whom such party might not otherwise choose to do business.

What lessons should be taken away from *First National*? The first is that whenever preliminary documents are exchanged during negotiations, great care should be taken to title the documents "Preliminary" or "Non-binding." One should avoid the use of the word "Final", unless and until the document is, in fact, intended to be "final", and thus enforceable. In addition, non-binding clauses should be included in all preliminary agreements. Such a clause may read: "This agreement is not intended to be a final binding agreement or contract and is of no binding effect. This agreement constitutes only a preliminary statement of the parties' intention with respect to the transactions contemplated in this agreement."

While individuals and entities should be mindful of the wording of their preliminary agreements, they should not disregard the usefulness of letters of intent or preliminary proposals altogether, notwithstanding the *First National* case. These preliminary exchanges serve a valuable purpose in many negotiations. In order to ensure that preliminary understandings are not taken to be final expressions with unintended consequences, it is essential that counsel include in such agreements express language that the agreements are preliminary and non-binding.

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[32] `http://www.sbllp.com/`
[33] `http://www.sbllp.com/`

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[34] http://www.sbllp.com/

The Bankruptcy Trustee – A Creditor's Friend

Friday, June 1, 2012

Marlene Weinstein

How many times have you been involved in state court litigation and your adversary advises you that his/her client has just filed bankruptcy? Don't fret – it may just be your lucky day! In order to understand how a bankruptcy can be used to your client's advantage, and often at nominal expense compared to the cost of continued litigation, it is necessary to understand the basic principles of "property of the estate" and "abandonment" as defined by the Bankruptcy Code.[1][35]

Upon the filing of any bankruptcy case, an estate is created. Property of the estate includes, but is not limited to, all of the debtor's legal or equitable property interests and most community property, as well as interests in property either recovered by a trustee, preserved for the benefit of the estate, or ordered transferred to the estate, such as avoidable preferences

[35] #_ftn1

and fraudulent transfers. See 11 U. S. C. §541(a)(1-7). In a Chapter 7 case, a trustee is appointed.[2][36] It is the trustee's job to review the assets of the debtor and to determine whether there are any non-exempt [3][37] assets that can be converted to cash for the benefit of unsecured creditors. If the trustee determines there are assets that can be sold or otherwise converted to cash, those assets will be administered and the funds distributed to unsecured creditors. However, if the trustee believes there are no non-exempt assets, or that the nonexempt assets that do exist are "burdensome … or of inconsequential value and benefit to the estate, " the case will be closed as a "no asset" case. When the case is closed, all of the debtor's scheduled property not otherwise administered by the trustee will be "abandoned" back to the debtor. See 11 U. S. C. §554.

Let's take a simple example to see how this works. Assume that prior to any bankruptcy, your client sold the debtor a mobile home, received some cash and took back an unsecured promissory note for the balance.[4][38] The debtor failed to pay, and your client sues. The debtor answers and files a cross-complaint seeking damages for repair costs he incurred based on your client's failure to make certain disclosures. The debtor then files a Chapter 7 bankruptcy case and the automatic stay imposed by 11 U. S. C. §362 prevents your client from proceeding with the lawsuit. Unless you believe you have grounds to allege that the debt should not be discharged, e.g. because the debt was incurred by the debtor's fraud, [5][39] the debtor will receive a discharge of your client's claim although your client will have a claim (albeit possibly worthless) against the bankruptcy estate. But what happens to the cross-complaint may depend on whether or not you contact the trustee.

The cross-complaint is property of the estate and should have been listed on the debtor's personal property schedule. Therefore, since the trustee stands in the shoes of the debtor, the trustee has the right to pursue the cross-complaint. Whether or not the trustee does decide to pursue the cross-complaint will depend on whether the trustee believes that the likely recovery to the estate will outweigh the cost of pursuing it.[6][40]

[36] #_ftn2
[37] #_ftn3
[38] #_ftn4
[39] #_ftn5
[40] #_ftn6

Prior to the Meeting of Creditors, the trustee will have reviewed the bankruptcy documents filed by the debtor, including all property scheduled and the property claimed exempt. The trustee will generally ask the debtor about the cross-complaint, or any pending litigation, and will make a determination as to whether the cross-complaint (if claimed exempt) is properly claimed exempt[7][41] or if not exempt, whether it is burdensome or of inconsequential value to the estate. It is often the practice in state court litigation to file a cross-complaint for defensive reasons, and without any information other than what is gleaned from the debtor, the trustee may very likely determine that the asset has no value to the estate. If there are no other non-exempt assets to be administered, the trustee will close the case, the cross-complaint will be abandoned back to the debtor who will then be able to proceed with the claim against your client in state court.[8][42] Although your claim may be able to be used defensively, you will not be able to recover anything from the debtor because any debt owed to you by the debtor would have been discharged.

But what if you had contacted the trustee and let him/her know that your client might be willing to settle the cross-complaint, as well as the claim against the estate, for a reasonable sum?[9][43] The trustee is always interested in a proposal that will generate money for unsecured creditors in addition to an amount sufficient to pay the trustee's administrative fees. If a deal can be negotiated, the state court litigation will be dismissed. When the bankruptcy case is closed, the cross-complaint will not be abandoned back to the debtor since it will have been settled and therefore, administered by the trustee. You will have achieved an excellent result for your client since the price paid to the trustee to settle the case will generally be far less than the cost of defending the cross-complaint in state court if the debtor elected to again pursue the claim against your client when it was abandoned.

The foregoing hypothetical assumes a simple set of facts; however, the process of resolving state court litigation by negotiating and settling with a trustee can be used when your client is involved in complex litigation with multiple parties. For example, your client may be able to obtain possession of equipment or other real and/or personal property that secures a debt

[41] #_ftn7
[42] #_ftn8
[43] #_ftn9

by negotiating a sale of the assets and/or a settlement of the dispute with the trustee, thereby eliminating the costs incurred in foreclosing against the property in state court. Similarly, if your client has a fraudulent transfer claim against a debtor, you may be able to negotiate with the trustee to either purchase the right to pursue the claim and/ or the right to receive the recovered asset(s) or a portion thereof. [10][44] In a case where there is a dispute as to ownership of property between your client and the debtor, your client may be able to purchase the debtor's interest in the property from the trustee. Even in cases where there are multiple parties, it may be possible to fashion a settlement that resolves all disputes. For example, in one case, my client entered into a settlement pursuant to which he paid the trustee a small fee, paid a third party involved in the litigation a small settlement, and was then assigned the third party's claim in the bankruptcy case, pursuant to which my client ultimately received some distribution.

It is important to understand that any settlement with the trustee or sale of estate assets must be approved by the Bankruptcy Court after notice of the settlement or sale has been given to all creditors and other parties in interest. Generally, 11 U. S. C. §363 provides the trustee with the authority to sell property of the estate. A settlement will ordinarily be approved by the Bankruptcy Court as long as it is fair and equitable.[11][45]

Conclusion

Litigation is expensive – settlement is generally in the best interest of all parties. The debtor's bankruptcy filing may provide you with an opportunity to achieve an excellent result for your client by resolving the pending litigation with a substantial saving of time and money.

Marlene G. Weinstein is a sole practitioner whose practice is devoted exclusively to Bankruptcy Law representing debtors, creditors and Chapter 7 trustees. She believes pre-bankruptcy planning is important and that it can sometimes be used as an effective tool in negotiations between parties involved in non-bankruptcy disputes. She often works with her clients in conjunction with their family law, tax, litigation and other non-bankruptcy attorneys. Her office is in Walnut Creek. She can be reached at (510) 472-0800.

[44] #_ftn10
[45] #_ftn11

[1] Unless otherwise stated, all statute references will be to sections of Title 11 of the United States Code, commonly referred to as the Bankruptcy Code.
[2] This article has been written with Chapter 7 {liquidation} cases in mind, although some of the information may be useful in Chapter 11 (reorganization) cases where an unrelated third party has been appointed trustee.
[3] Exempt property (property a debtor is entitled to retain) is determined by state law in California. A debtor is entitled to use the exemptions set forth in either C. C. P. §703.140 or C. C. P. §§704.010 et seq.
[4] Although you would think the seller would have secured the note (which would have made the hypothetical a bit more complex), these facts are based on an actual case.
[5] Certain debts, including but not limited to debts incurred by fraud or based on a breach of a fiduciary duty, may be excepted from discharge. See 11 U. S. C. §523(a).
[6] If the trustee does pursue the cross-complaint, your client should seek relief from the automatic stay to proceed with the complaint against the estate for purposes of determining your client's claim against the estate since your claim against the debtor personally will likely be discharged.
[7] The debtor may have some basis to exempt the cross-complaint (or certain types of lawsuits such as claims for personal bodily injury), or the proceeds derived therefrom, either in full or in part. See footnote 3.
[8] Even if other assets in the case were administered by the trustee, if the cross-complaint was not sold, settled or otherwise administered by the trustee, the right to pursue it will revest in the debtor upon the close of the bankruptcy case (even if it has been more than a year since the filing).
[9] An attorney I know who almost exclusively deals in state court recently had a matter arise which required obtaining information from the bankruptcy trustee. I advised him to give the trustee a call; however, he indicated that he had never had much success when he called bankruptcy trustees. This may very well be a familiar scenario with most state court attorneys. As we all know, it helps when you know the players and speak the language. In order to achieve the best results for your client, you may very well require the assistance of competent bankruptcy counsel.
[10] Although there has been a split of authority on whether or not a trustee can sell and/or assign his/her avoidance powers, the Ninth Circuit permits such actions to be sold or transferred. See In re P. R. T.e., Inc. (9th Cir. 1999) 177 F.3d 774 and In Briggs v. Kent (In re Professional Inv. Proper-

ties 0/ Am.) (9th Cir. 1992) 955 F.2d 623.
[11] In determining the fairness, reasonableness and adequacy of a proposed settlement agreement the court must consider: (a) The probability of success in the litigation; (b) the difficulties, if any, to be encountered in the matter of collection; (c) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; (d) the paramount interest of the creditors and a proper deference to their reasonable views in the [property}. In re A & C Properties (9th Cir. 1986)784F.2d 1377, 1381.

Pro Bono Spotlight: Katzen & Schuricht aim to preserve important bankruptcy law principle

Friday, June 1, 2012

Can you please provide a summary of the issue that caused you to get involved?

David Katzen (DK): *In Wolfe v. Jacobson (In re Jacobson), 2012 U. S. App. LEXIS 8103 (9th Cir. Apr. 23, 2012), the Ninth Circuit Court of Appeals held that bankruptcy debtors who successfully asserted a homestead exemption nevertheless lost the protected layer of value (here, $150,000), because a judgment creditor forced a postpetition execution sale of the house, and the debtors failed to reinvest their share of the proceeds in a new dwelling within six months. The court effectively reasoned that whenever a California exemption is allowed in a bankruptcy case, the debtor's right to postpetition proceeds from the exempt value is subject to California's time-limited protection of proceeds.*

Why was this issue important?

DK: *Although the circumstances in Jacobson weren't commonplace, postpetition sales of exempt property are hardly unusual. The ruling could jeopardize bankruptcy debtors' ability to retain ostensibly exempt proceeds from a sale by a bankruptcy trustee, by a secured party, or by the debtors themselves. As an example of the mischief wrought, the trustee in an unrelated case—who had sold an older couple's high-equity home, realizing several hundred thousand dollars for the estate but giving the debtors their $175,000 exempt share—has now reportedly demanded that they return that cash in reliance on the Jacobson holding; we're told these debtors hadn't even tried to reinvest in another house, because they need the cash for ongoing subsistence and medical expenses. As a matter of logic, the problem of a lapsing proceeds exemption could also arise from the postpetition sale of a vehicle, of exempt "tools," or of household or personal items.*

What caused you to step in and provide pro bono work when you did?

DK: *In our view, the Ninth Circuit's ruling is unsound both because it conflicts with prior circuit precedent and because it mistakenly "imports" state* *law to determine not merely what can be claimed as exempt in bankruptcy but also the effect of an allowed bankruptcy exemption. If exempt value is understood as "withdrawn" from the bankruptcy estate, as the weight of authority indicates, then there is no basis for proceeds from this reclaimed value to somehow be pulled back into the estate. Further, with limited exceptions, Bankruptcy Code § 522(c) provides that exempt property is "not liable" for prepetition debts either "during or after" the bankruptcy case. Thus, we think the value of exemptions allowed in bankruptcy is permanently allocated to the debtor's "fresh start," as a matter of federal law. Finally, it is perverse to use a California interval-limited proceeds shield—which is almost certainly designed to help debtors who have no other refuge—as a sword to cut off their rights under bankruptcy law. The Ninth Circuit's opinion did not address any of these points.*

To avert the harm to bankruptcy law and debtors posed by the opinion, the Jacobsons had to seek rehearing promptly—when we first learned of the decision on May 2 (only because Marlene Weinstein spotted it in the Daily Journal that day and called it to our attention), the deadline to file a petition was a scant five days off. However, the Jacobsons had no funds, and their appellate counsel did not expect to soldier on uncompensated. Fortunately, with that lawyer's cooperation, the debtors authorized Katzen & Schuricht to petition for rehearing. K&S undertook the project on a pro bono basis, because we feared that the initial ruling could be quite destructive, and our stepping in immediately appeared to be the best (if not the only plausible) way to restore equilibrium and preserve important principles of bankruptcy law.

What work did you provide?

DK:*Within the short time available, K&S conducted legal research, drafted a petition for rehearing, then filed it with the Ninth Circuit Court of Appeals.*

What do you hope your efforts will achieve?

DK: *Ideally, the Ninth Circuit will grant rehearing, vacate its initial opinion, and issue a new decision holding that allowance of the Jacobsons' homestead exemption removed the exempt layer of value from their bankruptcy estate and that—notwithstanding California's circumscribed window for reinvestment—Bankruptcy Code § 522(c) generally immunizes* *identifiable postpetition proceeds from any exempt property interest against collection on prepetition debts forever.*

When do you expect to hear the results of your efforts?

DK: *On May 10, the Ninth Circuit directed the trustee, who prevailed in the court's first opinion, to file a response to our petition for rehearing within 21 days. We assume the court will consider that submission and whether further oral argument is warranted, and then either set a date for another round of argument or just rule on the briefs. Though we cannot say for sure, we suspect that a favorable disposition would be forthcoming within the next six months. (An adverse outcome might be a lot quicker, but we're in no rush!)*

What would you say to other attorneys who are considering providing pro bono work?

DK: *Every once in a while, there's a chance to participate in potential "impact litigation" where the lawyer's commitment of resources is reasonably circumscribed, rather than open-ended. If the cause is right, this is an ideal context for a pro bono undertaking.*

David Katzen practices with Katzen & Schuricht[46] in Walnut Creek and has concentrated on representing parties in the insolvency context for over 30 years. He is recognized by the State Bar of California Board of Legal Specialization as a Certified Specialist in Bankruptcy Law and is also Board Certified in Business Bankruptcy Law by the American Board of Certification.

[46] `http://www.ksfirm.com/`

Bankruptcy Court Update: With Words of Wisdom From the People Who Matter Most – Our Judges

Friday, June 1, 2012

The local bankruptcy court for Contra Costa County is the United States Bankruptcy Court for the Northern District of California, Oakland Division[47]. It is located across the street from the big federal building in Oakland, at 1300 Clay Street. The courtrooms are on the second floor; the clerk's office is on the third floor. This court oversees most personal bankruptcy filings for residents of Contra Costa and Alameda Counties, as well as bankruptcies for many businesses in both counties.

To appear in this court, as well as the San Francisco, San Jose, or Santa Rosa division bankruptcy courts, attorneys must be admitted to practice before the District Court for the Northern District of California or get permission to appear *pro hac vice*. I suggest traveling to the court via BART, as it is only a block from the 12th Street / City Center station. However, parking is available at several nearby parking structures for those willing to pay.

Changes in the Courthouse

With the downturn in the economy, our court was inundated with new filings. From 2010 through 2011, our three judge bench saw over 28,500 new cases – about double what they would normally see. This led to longer calendars and greater lag times between filing a motion and getting an order. However, with filings decreasing (Oakland filings are down by almost 1,000 from this time last year) things are getting back to normal.

That said, if you haven't been to court in the past two years, you'll notice a big change. All of the judges you knew have retired, and you'll have to learn the rules and requirements of three new judges. To that end, here is a little information about our current bench.

Judge Efremsky

[47] `http://www.canb.uscourts.gov/`

Judge Roger L. Efremsky[48] was appointed in 2006, serving in San Jose's Bankruptcy Court. With the retirement of Judge Leslie Tchaikovsky, he was able to move up to Oakland in 2010. Prior to his appointment, Judge Efremsky was a partner with the AV rated law firm of Efremsky & Nagel representing corporate clients throughout California. He also served as advisory counsel to the Chapter 13 Standing Trustees for the Oakland, San Francisco, San Jose, and Santa Rosa divisions of the court. He is a former chairman of the National Association of Chapter Thirteen Trustees' Creditor Auxiliary and has served on a number of professional committees at the State and local levels.

Judge Efremsky has also testified on behalf of representative national creditors before the U. S. Senate Subcommittee on Administrative Oversight and the Courts regarding the role of the U. S. Trustee system. Judge Efremsky received his B. S. from Menlo College in 1978 and his J. D. from Santa Clara University School of Law in 1983. He was the recipient of a Rotary International Fellowship for the study of international law and politics at the University of Cape Town, Republic of South Africa.

Judge Efremsky is a frequent speaker at continuing legal education events. His words of wisdom to practitioners are to be prepared and courteous. "Being prepared for the hearing is paramount. That means counsel have a strong command of the facts and law at issue." It also means attorneys should be on time to hearings. He also stresses the importance of being courteous to opposing counsel, as well as clients, trustees, and court personnel.

Judge Lafferty

Judge William J. Lafferty III[49] was appointed in 2011 after Chief Judge Randall Newsome left the bench to work for JAMS. Judge Lafferty attended UC Berkeley where he earned his B. A. and University of California Hastings College of the Law where he earned his J. D. Following law school, Judge Lafferty clerked for the Hon. Thomas E. Carlson, who is still serving as a bankruptcy judge, with chambers in San Francisco. Judge Lafferty worked for Howard, Rice, Nemerovski, Canady, Falk & Rabkin from 1987 until his appointment to the bench in 2011. Among many other accolades, he

[48] `http://www.canb.uscourts.gov/judges/efremsky`
[49] `http://www.canb.uscourts.gov/judges/lafferty`

was recognized as a Northern California Super Lawyer from 2004 through 2010. He also served as President of the Bay Area Bankruptcy Forum and the Bar Association of San Francisco's Commercial Law and Bankruptcy Section.

Personally, Judge Lafferty enjoys spending time with his wife and son, growing grapes, and playing with his dog, who wakes him up every morning. He echoes the advice of his fellow judges about being courteous and proofreading papers prior to filing. He also wanted to share a practice pointer that may be unique to his courtroom. Occasionally, after he has read the papers, he will have questions for the attorneys. He asks attorneys to please respond to those questions directly, rather than pointing back to their briefs. He asks the questions because he may be unclear about a single point you raised, and your direct response to his questions will speed things along.

Judge Hammond

Judge M. Elaine Hammond[50] is the newest judge on our bench, having been appointed in February of 2012. She graduated with a B. A. from Duke University in 1992 and received her J. D. from the University of North Carolina School of Law in 1998. Following law school, she clerked for the Hon. Edward D. Jellen, who retired this year and whose seat she now occupies. Judge Hammond worked for the law firm of Murphy, Sheneman, Julian & Rogers until 2003, when she joined Friedman, Dumas & Springwater where she was a partner and focused her practice on Chapter 11 work, representing both debtors and creditors. She also represented a debtor in a rare Chapter 9 case. While in practice, she served on the State Bar's Insolvency Law Committee. She also served on the Bench-Bar Liaison Committee for the Northern District of California's Bankruptcy Court from 2011 until her appointment to the court.

Judge Hammond likes how bankruptcy touches on other areas of law and enjoys seeing the whole process of the case from initial meetings through discharge. While not working, she enjoys spending time with her husband and two children. She likes to garden, travel, ride a bicycle, and raise chickens.

[50] http://www.canb.uscourts.gov/judges/hammond

Her words of advice to the Bar are practical. Put the code section and case law you are relying on in your motions. Re-read your papers prior to filing them to make sure they make sense. Know what you want the judge to do if you win. Finally, if you are having a discovery dispute that cannot be resolved after a meet and confer with opposing counsel, call her chambers. Judge Hammond would prefer to resolve the matter through a phone conference with both sides prior to any motions being filed.

More Court Procedures

Attorneys have been required to file documents electronically[51] since 2005, and most of the documents filed in a case are immediately available through PACER[52]. Infrequent filers are temporarily exempted from electronic filing, but should still get ECF[53]training as quickly as possible. Free classes are held several times a month in Oakland and San Francisco.

All three of our judges use open calendaring for most hearings, and their courtroom deputies are available should you have difficulty locating the right calendar for your case. It is extremely important to meet and confer prior to your hearing. For example, attorneys (not staff) are required to talk via phone at least two weeks prior to a confirmation hearing and file a joint pre-hearing statement at least one week prior to the hearing, stating when they talked, what legal or factual issues remain, and how long the hearing will take. Failure to do so can lead to sanctions of $100 or more.

The court's website is full of local guidelines, procedures and rules[54] meant to help you. Please read them. From when and how you can appear by phone (in most cases, unless your client will be appearing in person) to when you need to provide chambers copies — it's all there. Each judge even has his or her own procedures page meant to help you succeed in their court (from the main website, click judges in the top center, then select your judge on the left, then click procedures). You can find all this and more on the court's website at www.canb.uscourts.gov. For Oakland specific procedures, please go to www.canb.uscourts.gov/procedures/oak.

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[51] `http://www.canb.uscourts.gov/ecf/ecf-home`
[52] `http://www.canb.uscourts.gov/public-access-court-electronic-records-pacer`
[53] `http://www.canb.uscourts.gov/ecf/ecf-home`
[54] `http://www.canb.uscourts.gov/procedures/oak`

As Judge Tchaikovsky once wrote – “Don’t substitute preparation with the opening statement: ‘I’m not a bankruptcy lawyer, but …’”

Corrine Bielejeski founded East Bay Bankruptcy Law in 2011, focusing on Chapter 7 and 13 debtor representation. She graduated with a B. A. from UC Santa Barbara in 2003 where she earned the University Service Award. She earned her J. D. from UC Davis in 2006, where she completed the Public Service Law program. She clerked for the Hon. Edward D. Jellen in the Oakland Bankruptcy Court, before entering private practice. She is a member of the Bankruptcy Court’s Bench-Bar Liaison Committee and invites the bar to contact her with any problems or suggestions that can be brought to the court’s attention. In her spare time, you can usually find her relaxing with a book, watching football, or hanging out with her husband and dog.

Food from the Bar: Law Firms Compete to Raise Funds for the Food Bank

Friday, June 1, 2012

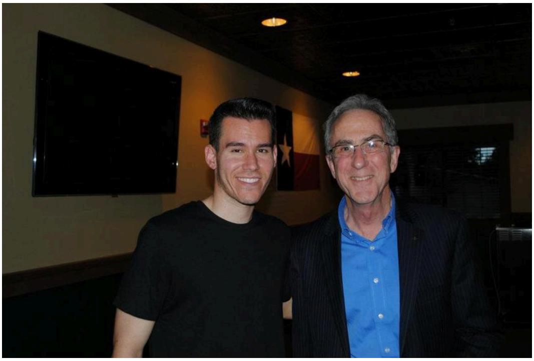
This year marked the 21st Annual Food from the Bar Drive[55], benefiting the Food Bank of Contra Costa and Solano[56]. Since its inception, the drive has collected nearly $900,000 and 54 tons of food for hungry Contra Costa County residents.

The two-week drive launched with a Comedy Night kickoff event featuring Don Friesen and Myles Weber. During the two weeks that followed, the Contra Costa County Bar Association[57] and its member law firms competed to raise food and money to benefit the Food Bank of Contra Costa and Solano. The drive culminated in a 5K Walk-a-Thon around downtown Walnut Creek. Participating law firms included Archer Norris[58], Buchman Provine Brothers Smith LLP[59], Timken Johnson LLP[60]and McNamara Ney Beatty Slattery Borges Ambacher LLP[61].

[55] http://www.cccba.org/attorney/build-your-practice/volunteer-food-from-the-bar.php
[56] http://www.foodbankccs.org/
[57] http://www.cccba.org
[58] http://www.archernorris.com/
[59] http://www.sbllp.com/
[60] http://timkenlawgroup.com/
[61] http://www.mcnamaralaw.com/

Walnut Creek Walk-a-Thon in support of the Food Bank

Comedian Don Friesen



Comedian Myles Weber with Food Bank Executive Director Larry Sly

Comedy Night Kick-Off at Back Forty in Pleasant Hill

Over the years, the competition has led to many creative fundraising efforts on the part of participating law firms. In the past, attorneys have auctioned or raffled goods and services, participated in walk-a-thons and some have even held head-shaving and cream-puff eating contests. To foster competition among participating law firms, the CCCBA declares winners in five categories based on the highest per capita contribution. Winners will be announced soon.

Please visit us on Facebook/CCCBA[62] to see more pictures from the Comedy Night[63] and the Walk-a-Thon[64].

[62] https://www.facebook.com/CCCBA
[63] http://www.facebook.com/media/set/?set=a.404479306250589.95075.156293777735811&type=3
[64] http://www.facebook.com/media/set/?set=a.407246075973912.95489.156293777735811&type=3

CCCBA Joins Effort to Support Funding the Courts

Friday, June 1, 2012

The Contra Costa County Bar Association[65] joined the effort to support adequate court funding by co-sponsoring the ”Stand up for Justice” rally on April 18, 2012 in San Francisco. State Attorney Kamala Harris, San Francisco Mayor Ed Lee, Bay Area Legal Aid Executive Director Ramon Arias, and many other speakers joined the rally, organized by the Bar Association of San Francisco and co-sponsored by numerous Bar Associations throughout the state. Here is a video from the rally, courtesy of California Courts News Report:

Access to Justice Committee Chair Nick Casper and Diversity Committee Chair Robin Pearson represented the CCCBA along with Executive Director Lisa Reep, Wendy Graves of Certified Reporting Services.

[65] http://www.cccba.org

To see more pictures from the rally, please visit our Facebook page at Facebook.com/CCCBA[66]

To see more news coverage and background information on the court funding crisis, please visit the Bar Association of San Francisco's very comprehensive coverage at www.sfbar.org/court-funding

[66]http://www.facebook.com/media/set/?set=a.390340820997771.92983.156293777735811&type=1&l=e719da9490

CoffeeTalk: Should bankruptcy judges be allowed to modify first mortgages (residential deeds of trust)? Why or why not?

Friday, June 1, 2012

Yes, Congress should at least experiment with letting bankruptcy courts treat home mortgages like other secured debts, which can be reworked in chapter 11 or 13 if the creditor is assured the economic value of its lien position. The Bankruptcy Code currently bars modification of home mortgages to make them safer for lenders and therefore more accessible to borrowers.

The housing bubble/meltdown was partly caused by TOO MUCH access. The foreclosure mess has been unnecessarily protracted because banks and loan servicers resist restructuring–especially, principal reductions on underwater loans–for several extraneous reasons, and debtors have no remedy.

Empowering bankruptcy judges to limit senior secured claims to the market value of the corresponding lien right would foster more constructive resolutions in and out of court–banks would net as much or more as they do on foreclosure and resale, and debtors who could support smaller loans wouldn't be uprooted for nothing. This fix would help the entire housing industry recover. Liberalized modification could sunset in, say, five years, and Congress could allow the amendments to lapse if home loans had become too scarce as a result.

- *David I. Katzen*, Katzen & Schuricht[67]

It is a logical approach to a difficult, wide-spread problem. One of the reason that so few loan modifications are being completed is that the lending industry has no real obligation to be responsive to the needs of its borrowers. The argument against modification in bankruptcy is that it will end residential lending as we know it. The same argument was made against loan modification under Chapter 12 (farm lending would dry up or be too

[67] `http://www.ksfirm.com/`

expensive); it didn't happen. The bankruptcy system works because there is a more level playing field for debtors. My personal belief is that if loans (for the debtor's primary residence) could be modified in bankruptcy, more loan modifications would be done outside of bankruptcy because, for the first time in ages, borrowers would have leverage.

- *Alan Ramos*, Steele, George, Schofield & Ramos, LLP[68]

The power of Courts to modify contracts, including first mortgages, should be limited and dependent upon the facts of each case. Is the Trust Deed a Purchase Money Mortgage? Is the secured property "under water", worth less than the amount owed? Have the parties tried to work out their own solution (e.g., by negotiation or mediation). Is the lender a commercial business, e.g. a bank/institutional lender, who could extend a loan for a longer term without any loss, or a private party, e.g. an elderly widow with limited resources who would be harmed by the modification? A good mediator could help guide the parties to a win win solution. A Court may just have to "cut the baby in half".

- Joel Zebrack, Attorney / Mediator

Although these probably aren't the situations that concern most people, bankruptcy judges actually can modify first mortgages when (a) the real estate involved isn't the debtor's principal residence or isn't the only security for the loan or (b) in Chapter 13, the entire mortgage debt will be due within five years after the date the case is filed. With respect to a loan that isn't due within the next five years and is secured only by a senior deed of trust on a person's principal residence, the arguments in favor of allowing the terms to be modified in Chapter 11 or Chapter 13 are probably obvious; the counterargument is that allowing such loans to be modified will cause mortgage loans to become more difficult to get and to have more onerous terms.

- David A. Schuricht, Katzen & Schuricht[69]

[68] http://sgsrlaw.com/
[69] http://www.ksfirm.com/